

Alberta Heritage Savings Trust Fund

BUSINESS PLAN 2008-11



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The Business Plan was reviewed and approved by Treasury Board on January 16, 2008, and was subsequently updated to reflect the most current information available. It is available for review and approval by the Legislature's Standing Committee on the Alberta Heritage Savings Trust Fund in due course.

STATUTORY MISSION

To provide prudent stewardship of the savings from Alberta's non-renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans.

BACKGROUND

The Alberta Heritage Savings Trust Fund (Heritage Fund) was created in 1976 to save a portion of Alberta's non-renewable resource revenue. From inception until 1987, the government set aside part of the Province's oil and gas revenue in the Fund. Since 1982 income from the Fund has been transferred to the General Revenue Fund and, to date, over \$30 billion has been made available to fund Albertans' priorities such as health care, education and infrastructure.

The Fund is managed as an endowment fund with the goal to maximize long-term returns at a prudent level of risk. The Fund is not to be used for economic development or social investment purposes.

Past public consultations have confirmed the importance of the Heritage Fund as an endowment, underscoring the need to preserve its real value over the long-term. The *Alberta Heritage Savings Trust Fund Act* includes an inflation-proofing provision requiring a portion of Heritage Fund income to be retained to protect its real value. Regular inflation-proofing of the Heritage Fund started in 2005-06 once the Province's accumulated debt was eliminated.

The Fund consists of investments in bonds, public and private equities, hedge funds, derivatives, real estate and other real asset investments such as infrastructure and timberlands. The assets of the Heritage Fund are globally diversified with investments in Canada, the United States, Europe, Asia, and the Far East.

Assets and income of the Heritage Fund are fully consolidated with the assets and revenue of the Province. All income earned during a fiscal year, except for amounts retained for inflation-proofing, is transferred to the Province's General Revenue Fund and is used to help pay for government programs and services.

In 2007-08, income of the Heritage Fund is forecast to be approximately \$938 million. Of this amount, \$466 million will be retained in the Fund to provide the inflation-proofing required by legislation with the remainder transferred to the government's General Revenue Fund. As a result of unanticipated surpluses, \$937 million¹ is available for deposit into the Heritage Fund to grow its real value. In 2007-08, \$918 million was deposited in the Heritage Fund with the remaining amount, that is currently forecast at \$19 million, to be deposited in 2008-09.

Note:

1 The amount of this transfer may change based on the year-end results.

FUND GOVERNANCE

The Minister of Finance and Enterprise is responsible for the management and investment of the Fund and is required to report on the performance of the Fund within 60 days of the end of each quarter and make public the annual report within 90 days of the end of the fiscal year. The Minister of Finance and Enterprise prepares the business plan and presents it for approval to Treasury Board and the Standing Committee on the Alberta Heritage Savings Trust Fund.

When investing the assets of the Fund, the *Alberta Heritage Savings Trust Fund Act* requires the Minister to adhere to investment policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return.

The *Alberta Heritage Savings Trust Fund Act* requires there to be a Standing Committee on the Alberta Heritage Savings Trust Fund which has representation from the major parties of the Legislature. The Standing Committee

reviews quarterly reports and approves the business plan and annual report of the Fund. The Committee reviews the performance of the Fund after each fiscal year end and reports to the Legislature whether the mission of the Heritage Fund is being fulfilled. An annual public meeting of the Standing Committee is held in different locations in the province. The purpose of these meetings is to update Albertans on the management of the Fund, answer questions and solicit input on its objectives.

The Minister of Finance and Enterprise is responsible for establishing the investment policy for the Fund. The Finance and Enterprise department provides portfolio analysis, research and investment strategy advice to the Minister. In 2003, the Minister established the Endowment Fund Policy Committee, adding private sector advice to the formulation of the Fund's investment policies. The committee has been disbanded and the Minister will receive that advice through both AIMCo and the Department of Finance and Enterprise with respect to the investment policy statements of the Fund. From time to time the Government may establish policy for investments and will provide that advice to AIMCo and the Department. Further, the Minister will assure that proper performance review and fund management principles are in place.¹

The investments of the Heritage Fund are managed by Alberta Investment Management Corporation (AIMCo) in accordance with the investment policies set out by the Minister of Finance and Enterprise. Some assets are managed directly by AIMCo personnel, while others are managed by external managers engaged and overseen by AIMCo.

The Auditor General is the auditor of the Heritage Fund.

Note:

¹ Change made subsequent to the April 22, 2008 release of the business plan.

GOALS, STRATEGIES & PERFORMANCE MEASURES

GOAL ONE

1

Maximize long-term returns at a prudent level of risk

What it means Investment income from the Heritage Fund is an important component of the government's fiscal plan. All Fund income, except for amounts retained for inflation proofing, is transferred to the General Revenue Fund and used to fund Albertans' priorities. Income for this purpose is determined using accounting conventions and is generally defined as interest income, dividend income and realized capital gains or losses. In order to provide the most benefit to Albertans, the fund must focus on maximizing returns over the long-term. However, the higher the return target, the higher the level of risk in the portfolio needed to obtain the target. Therefore, the Fund must adopt a prudent investment strategy that balances the level of risk with the goal of high portfolio returns.

The *Alberta Heritage Savings Trust Fund Act* provides for the maintenance of the Fund's real value by requiring the Heritage Fund to be inflation-proofed.

Strategies

- 1.1 Maintain and implement an asset mix that targets maximum long-term returns for the entire portfolio of investments with a prudent level of risk. The Heritage Fund's current Investment Policy Statement, established by the Minister of Finance and Enterprise, sets out the policy asset mix which is shown in Table 1 for information. This policy asset mix calls for globally diversified investments in both public and private equity, fixed income and real assets.
- 1.2 Through an on-going review process, ensure the asset mix remains optimal for achieving the goal of maximizing long-term returns at a prudent level of risk.
- 1.3 Retain investment managers who employ active management strategies with the objective of adding value above the benchmark portfolio without assuming undue risk.

Performance Measures	Last Actual (2006-07)	Target 2006-07	Target 2007-08	Target 2008-09	Target 2009-10	Target 2010-11
Five year Annualized Benchmark return ^{1 2}	7.7%	6.8%	6.8%	6.8%	6.8%	6.8%
Five year Annualized Active Management value added ^{3 4}	1.1%	0.50%	0.52%	0.57%	0.67%	0.77%
One year Active Management value added	1.3%	0.50%	0.60%	0.75%	1.00%	1.00%

Notes:

- 1 The Benchmark return target has been set as the Canadian Consumer Price Index (CPI) + 4.5%. The 5 year annualized Consumer Price Index measure is 2.33%.
- 2 Benchmark return is used to determine whether the asset mix as set out in the investment policy statement is achieving expected returns prior to any value added by active investment management.
- 3 All returns are net of fees unless otherwise noted.
- 4 Active management return is used to measure the impact of active fund management on investment performance. It is calculated as the difference between actual investment returns and the Benchmark return.

TABLE 1: Current Policy Allocation and Benchmarks

Allocation	Policy Benchmark ¹	Actual Asset Mix at Jan. 31, 2008 ²	Long-Term Target Asset Mix
Cash & Absolute Return Strategies			
Money Market	DEX 91-Day Treasury Bill	0.3%	1.0%
Absolute Return Strategies	HFRX Global Investable Index – Hedged C\$	5.7%	6.0%
Fixed Income			
Public Fixed Income	DEX Universe Bond Index	31.7%	24.0%
Inflation Sensitive			
Real Estate	Investment Property Databank Large Institutional Property Index	11.3%	10.0%
Private Income ³	CPI + 6%	1.8%	6.0%
Timberland ³	CPI + 4%	0.5%	2.0%
Equities⁴			
Canadian	Standard & Poor's / TSX Composite Index	16.7%	15.0%
US	Standard & Poor's 1500 Index	14.5%	15.0%
Non-North American	Morgan Stanley Capital International Europe, Australasia, Far East	14.2%	15.0%
Private Equity ³	CPI + 8%	3.3%	6.0%
Total		100.0%	100.0%
Overlay Strategies			
Active Currency Overlay ⁵		3.9%	5.0%
Absolute Return Strategies Overlay ⁶		3.4%	5.0%

Notes:

- 1 Descriptions of the various benchmarks are shown in Appendix B.
- 2 Asset mix is shown on fair value basis.
- 3 Higher allocations to private income, private equity and timberlands will be subject to the availability of attractive opportunities. There is generally a delay in completing allocations to these asset classes as actual dollar draw-downs lag fund commitments.
- 4 Long/short investing is allowed in some select equity classes. The long-term target weight reflects the net target exposure.
- 5 Allocations to active currency overlays are shown as targeted notional exposure. These strategies have notional exposure to various currencies, but generally have near zero net exposure.
- 6 Absolute return strategy overlays are investments in absolute return strategies that are used in conjunction with public equity indices to enhance portfolio returns.

RISKS TO ACHIEVING GOAL AND PERFORMANCE MEASURES

If the Fund's income is less than expected, the government fiscal plan may be affected. The return on risk-free assets such as Government of Canada bonds alone will not provide sufficient long-term returns. Assets that have some measure of volatility in their returns must be included in the portfolio in order for the Fund to meet its objectives. Therefore, investment returns and income will vary significantly from year to year and may underperform investment expectations for extended periods of time for the following reasons:

- Diversification among various asset classes lowers but does not eliminate the risk of loss.
- Equities have historically provided investors with higher total returns (dividends and capital gains) than fixed income investments. However, dividend yields in general are lower than interest rates, so an equity portfolio will provide lower current income while the magnitude and timing of capital gains are uncertain. There have been extended periods of negative returns from equities in the past.
- A well implemented private equity portfolio can provide investment returns above those of public equities. However, by their nature, private equity investments are riskier than public equity investments and are associated with an investment horizon of five to ten years to realize investment gains. Private equity investments are subject to risks such as illiquidity and potentially large or total investment loss.
- Private income investments such as infrastructure investments, bridge loans, and other corporate financing arrangements, provide current income, diversification and an inflation hedge. However, these types of investments are subject to a number of risks, including illiquidity, loss of principal and reduced income.
- Absolute returns strategies have gained prominence in recent years with an expectation of stable returns. However, this market is very fragmented with investment fees above those of traditional managers. In some cases there have been large losses sustained in the industry by otherwise well informed and highly professional investors. Manager selection and oversight are therefore critical to successful implementation.

Ensure the transparency of the Heritage Fund's objectives and results for Albertans

What it means Published reports and news releases will provide Albertans with access to information to enhance understanding of the Heritage Fund.

Strategies

- 2.1 Release quarterly and annual reports on a timely basis in simple, understandable language.
- 2.2 Release summary reports of the Heritage Fund's investment activities and results for Albertans on a timely basis.
- 2.3 Publish the Heritage Fund Business Plan annually.
- 2.4 The Legislature's Standing Committee holds annual public meetings around Alberta to report on the Heritage Fund's results and to answer questions on the Fund's performance.

Performance Measures

- Timeliness of reports and public accountability meetings.
- Annual report will be released by June 30 of each year.
- Quarterly reports will be released within two months after the end of the quarter.

INCOME AND EXPENSES

TABLE 2: Heritage Fund Income Forecast

Forecast Annual Income (\$millions)	Last Actual (2006-07)	2007-08	2008-09	2009-10	2010-11
Unconsolidated investment income	1,650	938	774	1,097	1,175
Fund Management & Administrative Expenses ¹	(2)	(4)	(5)	(5)	(5)
Amounts retained for inflation-proofing	283	466	279	334	340
Transfer to General Revenue Fund	(1,365)	(468)	(490)	(758)	(830)
Transfer to Heritage Fund	1,250 ²	937 ³			
Forecast fair value of the Fund (\$billions)	16.5	16.5	17.4	18.1	18.7

Notes:

- 1 Fund Management and Administrative expenses include both direct and indirect administrative expenses of AIMCo and the Finance and Enterprise Department. Expenses include staff time, supplies and services, investment service costs and advisory services for cost recovery purposes.
- 2 \$250 million of this allocation was for the Access to the Future Fund.
- 3 For 2007-08, the transfer to the Heritage Fund from the unanticipated surplus is subject to change in accordance with the province's surplus allocation policy. This transfer may change based on the year-end results. In 2007-08, \$918 million was deposited in the Heritage Fund with the remaining amount, that is currently forecast at \$19 million, to be deposited in 2008-09.

Forecasted income for the Fund in future years is lower than actual income in 2006-07 and the forecast for 2007-08. The reason is that the forecasts are based on long-term, normalized capital market return expectations. In recent years, the performance of capital markets in general has exceeded these expectations. Therefore the Fund has generated more income in recent years than the long-term average expected return.

The Heritage Fund income forecast is supported by the assumptions shown in Appendix A.

- The income forecasts include interest income, dividend income and realized capital gains or losses.
- Capital gains and losses on traditional investments are not recognized as income until the investment is sold or, given a significant loss that is expected to be permanent, is written down. Therefore, gains and losses that are included in reported market value rates of return may not be immediately reflected in income reported in the financial statements. (In the case of equity index swaps and futures contracts, gains and losses are realized in income as they occur.)
- The Heritage Fund records investments at cost, which exclude unrealized gains and losses. The fair value of investments is provided for information purposes. The Canadian Institute of Chartered Accountants public sector accounting standards regarding the accounting and reporting of financial instruments at fair value for governments are currently under review.
- Actual income and fair value results will vary from projections based on the extent to which actual market returns and interest rates vary from the assumptions used.

RISKS TO THE INVESTMENT INCOME FORECAST

- Fund income is dependant on both cash income (e.g. from dividends and interest) and realized capital gains (losses). Although cash income is relatively stable, capital gains are uncertain and subject to large variance.
- If equity returns are lower than assumed, investment income could be lower because stocks in the Fund could be sold for smaller gains than anticipated, or possibly for losses, depending on the extent of turnover in the various equity portfolios.
- If interest rates go up, the market price of bonds held by the Fund would typically decline. Sales of these bonds would produce smaller gains than expected, or, perhaps, losses, depending on the amount and timing of turnover in the portfolio.
- There are other risks in the portfolio including exchange rate movements and commodity price changes. The Fund has investments in foreign assets such as U.S. equities which are not hedged into Canadian dollars. If the Canadian dollar were to appreciate then this would detract from return. However, the Fund's investments in absolute return strategies, private income and foreign private real estate are hedged to the fullest extent practical, while fair value currency exposure of timberland is hedged. The Fund also has investments in commodity-based securities, such as timberland, which are sensitive to fluctuations in commodity prices.

TABLE 3: Heritage Fund Investment Expense Forecast¹

Forecast Annual Investment Expenses (\$millions)	Last Actual (2006-07)	2007-08	2008-09	2009-10	2010-11
Total Annual Expenses	55.0	64.0	72.6	80.7	88.3
As a percentage of fair value	0.33%	0.39%	0.42%	0.45%	0.47%

Notes:

- 1 Due to factors such as differences in assumed and actual experience in asset class allocations and growth in the size of the Heritage Fund, actual expenses may differ from forecast expenses. Forecasted expenses do not include external manager performance fees. The forecast reflects a change in methodology as compared to prior years' business plans. Salaries for internal staff previously allocated to direct management costs have been reclassified to the appropriate pools. Most notably, expenses in certain alternative asset classes have been forecasted based on committed capital. In 2008-09, a new cost system will be used to report Heritage Fund expenses.
- After fees, active management of the Fund produced approximately \$200 million of added value in 2006-07.
 - The Fund has recently increased its target allocation to such asset classes as Private Income and Private Equity and expects further increases in the future. These products are generally more expensive to run than traditional public equities and bonds. Therefore fees in both absolute terms and as a percentage of fair value are expected to rise. The increase to expected returns is expected to more than offset the increase in fees.

APPENDIX A:

Return and Asset Mix Assumptions

Long-Term Capital Market Rate of Return Expectations

Canadian public equities	8.00%
Foreign public equities	8.00%
Real estate	8.00%
Private Equity	11.00%
Private Income	9.00%
Timberland	8.00%
Absolute return strategies	6.75%
Value added by Active Management (total fund)	0.60%

Budget Assumptions	2007-08	2008-09	2009-10	2010-11
10-year bond rate	4.18%	3.50%	4.45%	4.75%
C\$/US\$ exchange rate	1.030	1.013	1.042	1.042

Asset Mix Weights¹

Money market	1%
Absolute return strategies	6%
Fixed income	24%
Real estate	10%
Public equities	45%
Private investments	12%
Timberland	2%

Note:

- 1 These are the long term asset mix weights assumed in the forecast model to forecast for future years. For 2007-08 we use actual asset weights up to and including January 31, 2008 and revert back to long term asset mix assumptions for the remainder of the forecast period.

APPENDIX B:

Definitions of Benchmark Indices

Consumer Price Index

Measures the rate of inflation in Canada as published by Statistics Canada.

HFRX Global Investable Index (Hedged C\$)

An index maintained by the Hedge Fund Research, Inc. that utilizes an objective rules-based methodology to diversify across hedge fund managers that have low correlations to traditional asset classes. This index is rebalanced quarterly and is passively investable. This is a U.S. dollar denominated index where the U.S. currency exposure is passively hedged back into Canadian dollars.

ICREIM/IPD Large Institutional All Property Index

An index maintained by the Institute of Canadian Real Estate Investment Managers/Investment Property Databank that measures the total return from the six largest Canadian peer funds, which individually have real estate portfolios valued greater than \$1.5 billion.

Morgan Stanley Capital International Europe, Australasia, Far East Index

An index maintained by the MSCI Index Committee that is designed to measure developed public market equity performance, excluding the U.S. and Canada. As of December 2006, the MSCI EAFE Index consisted of 21 developed market country indices representing approximately 85% of the market value of securities listed in the included countries.

S&P/TSX Composite Index

An index maintained by the S&P/TSX Canadian Index Policy Committee that measures the return on the largest companies and trust units listed on the Toronto Stock Exchange.

DEX 91-day T-Bill Index

An index maintained by PC Bond that represents the performance of Government of Canada 91 day Treasury Bills.

DEX Universe Bond Index

An index maintained by PC Bond that tracks the performance of most marketable, domestically issued, Canadian bonds with terms to maturity of more than one year. This index is comprised of Canada's, provincial, municipal and AAA-through BBB-rated corporate issuers.

Standard & Poor's Composite 1500 Index

An index maintained by the Standard & Poor's Index Committee that combines the S&P 500, S&P MidCap 400, and S&P SmallCap 600 indices to create a broad market portfolio representing approximately 90% of the market value of U.S. public equities.

APPENDIX C:**Definitions of Terms Used in the Business Plan****Absolute Return Strategy**

Absolute return strategies encompass a wide variety of investments with the objective of realizing positive returns regardless of the overall market direction. Investments in absolute return strategies are made through multi-hedge fund-of-funds and direct investments to increase strategy diversification.

Active Management

Managing the investments of a portfolio with the objective of outperforming the return of its benchmark. Active management generally takes two forms – security selection or asset allocation decisions. Security selection is the buying and selling of particular securities to earn a return above a market index. Asset allocation refers to changing asset class or sector weights to earn a return above what would be available from maintaining the asset class or sector weight in the benchmark.

Asset Allocation

The investment process by which the investment manager chooses or allocates funds among broad asset classes such as stocks and bonds.

Asset (or Investment) Class

Refers to a broad category of investments with similar characteristics (the typical asset classes are cash, stocks, bonds and real estate).

Benchmark

A standard against which performance is measured. Common benchmarks used in investment management are the DEX Universe Bond Index for Canadian fixed income, the S&P/TSX Composite Index for Canadian public equities, the S&P 1500 Index for U.S. public equities, among others.

Bond

A bond is a financial instrument representing a debt where the issuer (corporation or government) promises to pay to the holder a specific rate of interest over the life of the bond. On the bond's maturity date, the principal is repaid in full to the holder.

Capital Gain (or Capital Loss)

The market value received on the sale of an asset, which is higher (lower) than its purchase price (also called cost or book value). If an asset is bought for \$50 and sold for \$75, the realized capital gain or profit is \$25.

Diversification

Diversification is a process of allocation of investment assets within an Asset Class and among asset classes. Diversification is intended to reduce risk.

Dividends

Earnings distributed to shareholders of a company, proportionate to their ownership interest.

Equities

Equities are synonymously called stocks or shares and represent an ownership interest in a company (could be either a public or private firm). Shareholders normally have voting rights and may receive dividends based on their proportionate ownership.

Fixed Income Securities

An investment that is required to pay a fixed interest rate at periodic intervals such as bonds, mortgages and debentures.

Inflation

Increases in the general price level of goods and services. Inflation is one of the major risks to investors over the long-term as savings may actually buy less in the future.

Investment Grade

An investment grade bond is rated a minimum of BBB (or equivalent) by a rating agency, with AAA being the highest grade. Bonds rated below BBB are generally classified as being speculative grade and carry higher levels of credit risk than investment grade bonds (i.e., they have a higher probability of default on interest or principal payments).

Liquidity

The ease with which an investor can buy or sell an investment at a fair market price.

Money Market Instruments

Debt instruments such as Treasury Bills or corporate paper with a maturity of less than one year.

Nominal Rate of Return

A measure of the earnings performance of a fund measured in current dollars.

Overlay

A portfolio construction technique where the return and risk of an overlay strategy are added to another portfolio's returns without needing to transact in the underlying investments. To achieve this, the overlay strategy is usually executed with derivative securities on an unfunded basis, where notional exposure exceeds the invested capital. The overlay strategy modifies the risk exposure of the underlying investments

Portfolio

A collection of investments owned by an investor.

Private Equity

An equity investment in a private (not publicly traded) company.

Private Income

A private investment that is structured to provide high current income. Examples of investment opportunities considered to be private income include infrastructure projects, bridge loans and corporate finance arrangements.

Real Rate of Return

The nominal rate of return minus the rate of inflation.

Realized/Unrealized

Terms generally used to describe capital gains or losses. A gain or loss is generally realized when an asset is sold; prior to sale the gain or loss is unrealized and it is only a potential or "paper" gain or loss.

Swaps

Financial agreements whereby counterparties agree to exchange the returns they earn on their respective assets. For example, an investor might swap the return from his bond portfolio for the returns of another investor's stocks and vice versa.

Timberland

Refers to investment in privately owned areas of woodland; that is, forested areas consisting of both hardwood and softwood species. When responsibly managed, timberland investments are a renewable and sustainable resource that responds to demand for lumber and paper products, and provides benefits such as diversification, an inflation hedge, and relatively high yield within the context of a portfolio.